A PHASE OF INTERLOCKING DIRECTORATES.

THIS title may be rather misleading. For it is not the purpose of this article to discuss the public or civic questions which may be involved in legislation prohibiting interlocking directorates. Nor is it intended to discuss questions of fraud of directors, whether affecting stockholders, or the corporations controlled by interlocking directorates.

The point to be made in this article is whether two or more corporations controlled by the same board of directors, and same officers, are severally and jointly liable to third parties for the negligence, or breach of contract, or default of one of the corporations.

Under our Federal form of government, a corporation created by one State is deemed a foreign corporation in every other State. The different States have adopted laws prescribing what foreign corporations must do in order to carry on any business in such State. These regulations are in many cases burdensome, and, in some cases, are impossible of fulfillment.

In this country it has been found advisable for large business affairs to be carried on by corporations. By reason of the State regulation of corporations, it is frequently necessary for a great business association to organize corporations in several of the different States wherein their business is located, in order to conduct such business properly. The reason for this is the necessity of dividing the responsibilty and liability of the different corporations in performing the duties and attending to the details of the business in the different States, the regulation of taxes, the exercising of the power of eminent domain, and otherwise complying with the laws of the States in which such business is transacted.

It may be well, at the outset, to revert to the early decisions relating to corporations, especially as to the citizenship of a corporation. In so doing, for the present, the general recognition of the separate and distinct legal entity of a corporation must be

laid aside. Under an early decision it was held that a corporation was not a citizen.

In Bank *v.* Deveaux [1] Chief Justice Marshall says:

> "That invisible, intangible and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and consequently cannot sue or be sued in the courts of the United States unless the rights of the members, in this respect, can be exercised in their corporate name."

Then again in Covington Drawbridge Co. *v.* Shepherd [2] it was said:

> "No one, we presume, ever supposed that the artificial being, created by an act of incorporation, could be a citizen of a State in the sense in which that word is used in the Constitution of the United States."

Then again in Muller *v.* Dows [3] the court said:

> "A corporation itself can be a citizen of no State in the sense in which the word 'citizen' is used in the Constitution of the United States. A suit may be brought in the Federal Court by or against a corporation, but in such a case it is regarded as a suit brought by or against the stockholders of the corporation, and for the purpose of jurisdiction it is conclusively presumed that all the stockholders are citizens of the State which by its laws created the corporation."

During this development of the law there was a fiction of fact that the stockholders of a corporation were exclusively citizens of the State, under the laws of which the corporation was organized. Later that position was tested by allegation and proof that such stockholders were not citizens of such State. The courts then adopted the ruling as a presumption of law, not to be defeated by allegation or evidence to the contrary.

In Southern R. Co. *v.* Allison [4] the court, discussing this position, quoted with approval a former decision, as follows:

> "That doctrine began, as we have seen, in the assumption that State corporations were composed of citizens of the State

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[1] 5 Cranch 86.
[2] 20 Howard 227.
[3] 94 U. S. 444.
[4] 190 U. S. 326.

> which created them; but such assumption was one of fact, and was the subject of allegation and traverse, and thus the jurisdiction of the Federal Courts might be defeated. Then, after a long contest in this court, it was settled that the presumption of citizenship is one of law, not to be defeated by allegation or evidence to the contrary. There we are content to leave it."

I think it may be now taken as the settled doctrine in this country that, for purposes of Federal jurisdiction, a corporation is conclusively regarded as a citizen of the State in which it was originally incorporated.

Another aspect of the question involved is the tendency to disregard form for substance. The Kentucky Court of Appeals has held: [5]

> "In determining the liability of the corporation the court will look at the substance and not the mere form."

The Supreme Court of New York has used this language: [6]

> "We have of late refused to be always and utterly trammelled by the logic derived from corporate existence when it only serves to distort or hide the truth."

The court of Nebraska has held: [7]

> "The court may look behind the corporate existence when it is necessary to do so, in order to do equity."

From this it seems there is a tendency to recede from the doctrine that the separate and distinct entity of a corporation will avail to defeat any claim against such corporation, by reason of its connection and possible control by another corporation.

A fruitful field of litigation has been caused by loss or damage to freight shipped over several connecting carriers. It has been earnestly insisted that the different connecting carriers in a through line form a partnership, and are therefore severally and

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[5] Southern R. Co. in Ky. *v.* Thomas, 28 Ky. L. 951, 90 S. W. 1043.
[6] Anthony *v.* American Glucose Co., 146 N. Y. 407, 41 N. E. 23.
[7] Home Fire Ins. Co. *v.* Borden, 67 Neb. 644, 93 N. W. 1024.

jointly liable for injury and damage growing out of negligence of any one or more of the connecting carriers.[8]

Among the many cases supporting this doctrine is that of Wyman *v.* Chicago R. R. Co., etc.[9] The court says:

> "It may be regarded as equally well settled, upon authority, that where several common carriers having each its own line, associate and form what to the shipper is a continuous line, and contract to carry goods through for an agreed price, which the shipper or consignee pays in one sum, which the carriers divide among themselves, then as to third parties with whom they contract, they are jointly and severally liable for a loss taking place on any part of the whole line, and the word partners and any similar particular word to describe the relation existing between the carriers, need not be used in the declaration or petition."

One of the strongest cases holding one corportaion, with practically the same directors and officers as another corporation, liable for the negligence or tort or breach of contract of such other corporation, is that of the Southern R. Co. in Ky. *v.* Thomas.[10] In this case the court held as follows:

> "The Southern Railway Company in Kentucky showed by its agent that it had no lines outside of the State of Kentucky, and that its line terminated at Burgin. But he also stated

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[8] This rule has been thus stated in 6 Enc. Law (2d ed.), 655: "If the several lines are under one management and control so as to constitute a system,' or have contracts by which their continuous roads are held out to the public as a 'line' for through transportation, the roads constituting the line or system are jointly liable for injuries occurring to goods while being carried over their through line. Wherever there is an identity of interest, or the companies have placed certain features of their business under one general control, although the general management of each road is retained by its owners, the companies are, as to such features of their business, partners, and liable as such.

This same conclusion is reached in 6 Cyc. 478, wherein the author says: "By joint arrangement between carriers operating connecting lines, a partnership may arise by which each is liable for breach of the duty of carrier by any one of them in the course of the transportation, and suit may be brought against any one for the loss."

[9] 4 Mo. App. 35.

[10] 28 Ky. L. 951, 90 S. W. 1043.

that Mr. Spencer, who is the president of the Southern Railway Company, was also the president of the Southern Railway Company in Kentucky. No charter of the Southern Railway Company in Kentucky was given in evidence, although the witness stated that the company had a separate charter from the Southern Railway Company, and it was shown that the two roads are under the same executive control. It was also shown that the checks to the men employed by the Southern Railway Company in Kentucky come from the headquarters of the Southern Railway Company, and that the stationery of the Southern Railway Company in Kentucky is furnished by the Southern Railway. The contract made with Thomas is made in the name of the Southern Railway, and not in the name of the Southern Railway in Kentucky, although its name is stamped at the head of the contract. There was other evidence tending to show that the Southern Railway in Kentucky is a division of the Southern Railway Company, and under the same management. Taking all the proof together, there was sufficient proof to warrant the jury in concluding that the Southern Railway in Kentucky is simply one of the divisions of the Southern Railway Company, and that although a different corporate name is used, it is the same thing as the Southern Railway Company, the name only being changed by adding the words 'in Kentucky.' In determining the liability of the corporation, the court will look at the substance, and not the mere form."

While this case goes farther than any of the decided cases, yet it seems that this conclusion could have been reached solely on the liability of an initial carrier, or on the above theory of partnership. It is not necessary to determine, as this in effect does, that two distinct corporations having the same officers and directors are both liable for the negligence of one. The early rule was that a carrier was only liable, unless bound by a special contract, for its own negligence. Especially was this true where, under the terms of the contract, it was stipulated that the contracting carrier should only be liable for injury suffered while freight was under its control, and that it should not be responsible for injury received after such freight has been delivered to its connecting line. However, under the doctrine of partnership, as above stated, it is apparent that there will be more insistence on the liability of each carrier composing the through route, to

compensate the shipper for injury received, whether the damage was occasioned by the carrier sued, or by one of the connecting carriers.

There is another line of decisions, which would completely eliminate liability of the corporation, not in itself at fault, for the act of a corporation controlled either by stock ownership, or interlocking directorates, or the same officers. This seems to be the correct rule.

In Louisville Gas Co. *v.* Kaufman Straus Co. [11] it is said:

> "There is no hint here that the gas company is attempting to use the other corporation as a cloak for wrong doing. The business of the light company has proceeded as it did before the various stockholders sold their shares to the gas company. The public has continued to deal with the regular Board of Directors of the light company, and that company has retained its own officers and employees, its own pay rolls and its own franchise, property and plant. There has been no conveyance of any franchise, property or plant by the light company to the gas company. The purpose of all this is manifest, and that purpose is entirely legitimate. The rights and powers of the light company were more comprehensive than those of the gas company. The former was empowered to furnish electricity as a motive power, while the latter was authorized to manufacture and sell it for illuminating purposes only.
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> "It is true that, as the sole stockholder, it owned the business and controlled it, but only as stockholders in all corporations may be said to own and control the affairs of their corporations. Even in the Eisman case, where no corporate body was kept alive, individual liability on the single shareholder was not imposed, because it was said by the court that the entire credit was given to the corporation, no fraud had been practiced by the stockholders, and the creditor had gotten all he had bargained for. It was further said that the creditor was in the same attitude after Eisman's purchase of the stock as he was before; he was not injured or his interests affected in any way by such purchase. Such is the case here. The corporate property of the light company has not been conveyed to any one, and the business is being conducted as it was before the change of stockholders. The 'good faith' required in the Eisman case to prevent

[11] 105 Ky. 131, 48 S. W. 434.

suspension is that which keeps alive the organization for legitimate purposes, as against the purpose of using the mere corporate name for illegitimate or fraudulent purposes.

"It is agreed that by the purchase of this stock the gas company was simply carrying out the purpose of its charter amendment, which enabled it to manufacture, distribute and sell electricity for illuminating purposes. But, as we have seen, it did not acquire under its charter the right to manufacture and distribute electricity for supplying motive power. The electric light company alone had this right. If the gas company purchased the stock only as a means to an end—that of manufacturing and selling electricity for illumination—it would have confined the business to that end. It did not attempt to do this, but the light company continued to operate its own franchise with the power and rights conferred in its charter. It is not true that the gas company could only lawfully buy stock by assuming the ownership of the business. The gas company by purchasing the stock of other companies, as authorized by its charter amendment, could at last only become a mere stockholder, and this the law makers must be supposed to have known. It was, therefore, as a controlling stockholder, or, if need be, a single stockholder, that the law contemplated it might control the manufacture, sale and distribution of electricity.

"In this sense, and in this way, the stockholders of all corporations do own and control its business."

Thus in Calor Oil & Gas Company *v.* Franzell,[12] the court said:

"The fact that the Louisville Gas Company owns a majority, or even all, of the stock of the Calor Oil & Gas Company does not vacate or destroy the corporate rights of the latter corporation. The Calor Oil & Gas Company retains its separate corporate entity, and has all the powers and rights which it would otherwise have if its stock was in the hands of a number of individual holders."

Quoting from the syllabus of Richmond & I. Const. Co. *v.* Richmond N. I. & B. Co., etc.:[13]

"The fact that the stockholders in two corporations are the

[12] 128 Ky. 715, 109 S. W. 328. [13] (C. C. A.), 68 Fed. 105.

same, or that one corporation exercises a control over the other through ownership of its stock, or through the identity of the stockholders, such corporations being separately organized under distinct charters, does not make either the agent of the other, nor merge them into one, so as to make a contract of one corporation binding on the other."

It was said in Waycross R. R. Co. *v.* Offerman R. R. Co.: [14]

"One corporation may own all the stock in another corporation, but notwithstanding this, the two corporations would not become merged, but would remain separate and distinct persons."

In addition to the foregoing, the Court of Appeals of Kentucky in December, 1913, in the case of the Louisville Railway Company *v.* Wiggington,[15] says:

"The defendant pleaded and showed that it had conveyed the right of way to the Louisville and Interurban Railway Company, and that this corporation built the railroad and operated it, the Louisville Railway Company having nothing to do with it. But the proof showed that the Louisville & Interurban Railway Company is a corporation under the same control as the Louisville Railway Company, having the same president, the same general manager, the same paymaster and the same officers to employ and discharge servants and agents. But this is not sufficient to show that one corporation is liable for the debts of the other. Two corporations may, though operated by the same officers, be entirely distinct. The articles of incorporation of the Louisville and Interurban Railway Company are in the record and show that its stock was regularly subscribed for by certain individuals. It is a going concern, doing business regularly and may be sued for any liability incurred by it; but the Louisville Railway Company is not on the facts shown liable for its defaults. (Louisville Gas Co. *v.* Kaufman Straus & Co., 105 Ky. 131; Calor Oil & Gas Co. *v.* Franzell, 128 Ky. 730). In Southern R. R. Co. *v.* Thomas, 90 S. W. 1044, the proof was materially different from that in this case. Facts were shown there which do not appear here.

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[14] 109 Ga. 828, 35 S. E. 275.
[15] 156 Ky. 400, 161 S. W. 209.

> "The Circuit Court improperly held that the action could be maintained against the Louisville Railway Company for wrongs done by the Louisville and Interurban Railway Company after the conveyance of the property by the Louisville Railway Company to it."

Several cases have recently been brought against oil companies organized under the laws of adjoining States. These several corporations were created for certain essential business principles, and were not organized with a fraudulent purpose. The controlling influence of each was identical. For instance, one oil company organized in one State was a refining company engaged in refining and selling oil to any one who desired to buy. The second company was organized in another State to do business in a State separate and distinct from the State under which the former company was organized, and in which it performed its duties of refining and selling oil. As a matter of fact the second company bought its oil from the first, and hired from the first company an oil wagon to deliver the oil across the State boundary to the customers of the second company. This wagon was driven and the oil delivered by an employee of the first company, although the second company paid the first company the wage of such agent and hire for the wagon. In these cases the oil delivered by the second company, in the adjoining State, was said to have been below the legal test and requirement of the second State, or that the agent, delivering such oil, had placed the oil in a tank which had held gasoline and thereby reduced the fire test of the oil. A purchaser from the retail merchant not knowing that gasoline had been mixed with such oil, used the oil for the purpose of kindling a fire, which caused an explosion, resulting in the severe burning of every member of the household.

Under this state of facts, was the first corporation in any way liable for such supposed negligence of the driver, then in the employ of the second company, or for any failure of the oil sold to comply with the legal test of the State in which such oil was delivered? Much litigation grew out of this transaction. Such claims will probably occur frequently in the future. However, no decision was reached here, because the parties

compromised and settled the matter. Some of the courts refused to require the plaintiff to elect against which of the corporations the action should be prosecuted, holding, in effect, that the interlocking directorates and the close connection between the two corporations rendered both of such corporations liable for these injuries. It is hard to prophesy in what way such cases will finally be decided. The court should adhere to the old doctrine that each corporation is a separate and distinct entity, and hence that one should not be liable for the tort, negligence, or breach of contract of the other. Under the complex condition of the various State laws, it will be more and more necessary for a large business to use the agencies of many corporations, organized in different States, to thoroughly comply with the State laws, to properly regulate the liabilities and duties of the corporate employees, to enable some corporations connected with the main company to exercise the power of eminent domain, and properly finance the business.

In the construction of railroads the two latter requirements are most vital. In many cases it will be found absolutely necessary to organize two or more corporations in order to secure funds to carry out the purpose of the corporation and to perform its duties to the general public. The law is in more or less of a formative state. It would be a detriment if the courts, in their desire to be untrammelled by form, should make it impossible for any business to expand by means of separate corporations, separately financed and separately managed, simply because of certain hardships that may result in some cases. Hard cases make bad law. One corporation, when legally authorized so to do, may hold stock in another corporation. This corporation, being a mere stockholder, although a controlling stockholder, should not be held to answer for the debts, defaults, or negligence of the other corporation.

It would seem unreasonable to hold that two corporations, organized under separate charters, whether under the laws of the same State or not, should be regarded as the same corporation or merged into one, simply because the two corporations happen to have some of the same men in official position, and have interlocking directorates. Nor should one of the corporations be

liable for the acts, contracts or defaults of the other. If this construction of the law is not true, then no set of men could control two corporations, however different in their character, or in their duties and obligations to the public, however solvent or insolvent one or the other might be, without rendering the one liable for the defaults of the other. It is entirely reasonable to hold two corporations, controlled by the same officers and directors, and practically parties to the same contract with a third person, liable to the other contracting party. But one corporation, which has no part in a contract, or in the performance of the work done under such contract, ought not to be held liable for any injury or damage resulting from the performance, or breach, of such contract, simply because this corporation happens to have in control the same men that manage the former corporation.

If this doctrine is not sound, then the directors of a railroad company, who are also directors of a bank or mercantile corporation, would render the bank or mercantile corporation liable for the acts or defaults of the railroad company. Both reason and authority agree that the mere fact of interlocking directorates, or identical officers in two or more corporations, is not sufficient to render both corporations liable for the acts or negligence of one of the corporations.

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